May 22, 1998

Ray Williamson
Acting Director, Utilities Division
Arizona Corporation Commission

Docket #: RE-00000C-94-0165

**Re: COMMENTS OF NGC CORPORATION On Staff's Position Paper**

The purpose of these comments is to provide NGC's views on a number of the issues raised by Staff in its May 19, 1998, Position Paper. NGC Corporation is one of the county's leading marketers of energy products and services. Through its Electric Clearinghouse ("ECI") subsidiary, NGC is the second leading wholesale power marketer in the industry. Through Natural Gas Clearinghouse, NGC is also the second largest natural gas marketer in North America, having marketed more than 8 billion cubic feet per day in 1997. ECI's sales volumes grew from 15 million-megawatt hours in 1996 to nearly 95 million-megawatt hours in 1997 – a significant portion of which was traded in the Southwestern United States.

In addition, through its Destec Energy subsidiary, NGC has an interest in 20 operating power generation facilities located in California, Texas, Georgia, Virginia, Michigan, and Nevada with generation capacity exceeding 4,000 megawatts. NGC does not currently have generation assets located in Arizona, but is very interested in merchant plant or industrial cogeneration opportunities in the State.

NGC has monitored the proceedings in Arizona with great interest over the past year-plus. NGC representatives have participated on several ACC-led workgroups, including the Safety and Reliability Workgroup, and the ISO and Spot Market Workgroup.

## THE REAL SOLUTION

NGC applauds the ACC Staff for its recent attempt to "put meat on the bones" of the Commission's restructuring initiative. NGC supports the implied message that divestiture of generation by vertically-integrated utilities is the only way to ensure that competition flourishes in a restructured electric industry. To allow the development of a fully competitive electricity market that is accessible to a broad range of suppliers and purchasers, the present concentration of generation market power must be addressed. Today's utility incumbents are: (a) the sole or **monopsonistic purchasers** of generation *for their service territories*; (b) **competing sellers** of generation within their service territories; and (c) compensated based on the size of their **investments in generation.**

The incentives to favor owned versus competitive generation are painfully obvious. Today, this basic industry and utility structure is simply not conducive to robust competition. Major changes in the pattern of ownership of generation and transmission are necessary before the potential for the exercise of market power is lessened sufficiently for there to be an open and competitive wholesale market. The introduction of an Independent System Operator (ISO) alone will not provide sufficient safeguards against the potential for exercise of vertical market power - the creation of the ISO merely makes a promise that all players will have comparable access to the transmission system.

In the end, without willing and able buyers in the marketplace, market participants may have "access," but that "access" will not be to a robust, competitive market. Today's wholesale market is not very well populated with willing buyers and sellers. There is a shortage of buyers with clear incentives to buy power at the lowest cost. Traditional investment-based rate making provides incumbent utilities with very strong incentives to dispatch their own generation. And one seller, the local IOU, historically dominates the generation market, particularly in localized regions. The wholesale market must have ample supplies of sellers and buyers or competition simply will not work effectively. A structural solution is needed to expand the pool of legitimate buyers.

After considering the various electric restructuring models available, NGC has reached the inescapable conclusion that divestiture of investor-owned utility generation is the model that best accomplishes numerous desirable objectives including:

- **Elimination of vertical market power** resulting from ownership, control and integrated operation of the generation, transmission and distribution components of the electric power system;
- **Reduction of horizontal market power** resulting from the control of large amounts of generation in defined markets, especially in those markets referred to as "load pockets". Generation assets should be sold in "blocks" rather than as entire portfolios or else any horizontal market power will simply be transferred to the purchaser[1];
- **Reduction of stranded costs** by maximizing the market value, which minimizes and in some cases eliminates any excess of book value over market value. Several utilities have sold their generation assets for more than book value;
- **Accurate determination of current market value.** Administrative determinations of "market value" are poor substitutes at best;
- Creation of additional **competition in the provision of generation services.** Putting the same amount of generation in the hands of more owners will create more competition which will drive down prices;
- Significant **expansion of the number of energy and capacity buyers** (distribution only utilities) with the incentive to seek the lowest cost power available; and
- Enhance the competitiveness of the wholesale market, which will result in **lower prices for all consumers.**

As has been proven in California and New England, and is in the process of being proven in New York and Massachusetts, divestiture of investor utility-owned generation can actually minimize the potential disruption inherent in a market paradigm shift. As is clear to everyone involved in this shift, stranded costs loom as a potential deterrent to change. Indeed, the core issue in every electric restructuring debate is stranded costs.

---

[1] The size of the block should be sufficient to assure that buyers can purcahse enough generation in a given area to take advatage of economies of scale and synergies between plants; conversely, the blocks should be small enough to guard against the transfer of market power from the IOU to another entity. This is a something that can be examined with respect to specific relevant markets.

Estimates of stranded costs tend to be staggering, yet in reality they tend not to be nearly as great as predicted.

Stranded costs are generally defined as the dollar amount by which the book value of a utility's generation assets exceed the **current market value.** Determining the current book value of these assets should be a fairly straightforward process. Determining the current market value of the assets is much more controversial question, however. The definition of market value is the price that comparably situated willing buyers and willing sellers agree to in a fair trade.

The lost revenues approach is *not* the appropriate mechanism for calculation of potential stranded costs. As noted by economist William D. Norhaus in comments to the FERC in Docket No. RM95-8-000, *et al.* (the "Mega-NOPR"):

> [F]rom an economic point of view, in its proposal for levying the stranded asset tax FERC is committing the cardinal regulatory sin of turning sunk costs into marginal costs....[S]tranded costs are in effect sunk costs: by elementary economic principles, they are bygones and should therefore not affect current decisions. What FERC is proposing is that these sunk costs can be converted by utilities into variable costs, thereby affecting current decisions and causing economic inefficiencies.

In effect, the revenue-lost recovery mechanism takes sunk book costs that exceed market (or replacement) value and makes them function as marginal costs: This is not an appropriate approach, as it neither determines the true fair market value of the plants or resolves the market issues addressed above.

As noted by CCEM in its Mega-NOPR *Reply Comments On Stranded Costs and Market Power*, the choice of a revenue lost approach for stranded cost quantification substantially lessens the likelihood that customers will access the free market:[2]

> It should be recognized that if the minuend and subtrahend of the revenue-lost equation are accurately defined, then the resulting charge to departing customers would defeat any economic reason for leaving an incumbent, high-cost supplier for a lower cost competitor, at least during the period

[2] *See Reply Comments of the Coalition for a Competitive Electric Market on Stranded Costs and Market Power* at p. 7.

> for which revenues are deemed to be owed to the incumbent and reduces incumbent suppliers incentives to become lower cost, more efficient providers to captive customers. As characterized by the Virginia Corporation Commission, revenue lost deters a present customer from pursuing competitive options by presenting it with the Hobson's choice of "staying with the existing [incumbent] utility and paying a higher than market rate, or leaving the utility and paying a market rate plus stranded cost." *Virginia Corp. Commission* at 56.

Since assets are valued differently in regulated and competitive environments, ultimately, NGC supports a market-based approach to quantification of potential stranded investment. Under a purely regulated regime, an asset's market value will equal its book value.[3,4] Such a situation differs from that experienced under competition, where the value of an asset equals the expected present value of the profits an asset can generate under its *best use*, which equals the excess of expected revenues over expected costs.[5] This will be reflected in the prices buyers are willing to pay for assets in an auction. The market-based approach is eminently preferable to attempts to quantify such costs using a lost revenue approach, or any attempt to administratively determine a utility's Excess Cost Over Market.

In short, because of the complexities in any administratively-determined stranded cost number, only the market itself can accurately value, what, if anything, is stranded. Divestiture through an open auction is the best and most accurate method to determine the true market value of utility owned generation assets, and thus, to ascertain a true measure of stranded costs. Any administrative method is simply a poor substitute for determining the real market value of the assets.

Finally, divestiture allows financial markets to work more effectively. In the new world, generation and transmission/distribution have different risk profiles. Separating the two will allow those investors who are more risk averse to hold stock in

---

[3] See *Different Approaches to Estimating Transition Costs in the Electric-Utility Industry*, Oak Ridge National Laboratory, ORNL/CON-423, October 1995, p. 8.

[4] "In principle, the future revenues from an asset should equal the investment made in the asset plus the shareholder's return on investment (ROI)." Ibid.

[5] Ibid.

transmission/distribution, and those who are less averse to risk can hold generation stocks. Holders of generation stocks can thus share some of the "upside" of efficiencies gains spurred on by competition, to the extent that more efficient competitors are able to keep some of those gains after passing a portion along to the marketplace.[6]

*In order for a competitive market to flourish, there must be a sufficient number of both buyers and sellers. In short, only with a major change in the pattern of ownership of generation will the potential for the exercise of market power be lessened sufficiently for there to be an open and competitive market.* ***It is critical, therefore, to fully separate the monopoly business from the potentially competitive functions.*** Further, the distribution functions of the incumbent utilities should also be separated from their power generation operations.

## AN INTERIM APPROACH

We are cognizant, however, that Staff has recognized that, while divestiture is the cleanest and most effective way to address market power issues, other alternatives may, *in the short run*, provide some of the benefits of divestiture. NGC agrees that one alternative might be to segregate generation as a separate profit center within the corporate structure. Transactions between a "utility" generation unit and other affiliates would be limited to those activities for which there are published tariffs or posted rates.

During the transition to full retail competition, NGC supports the Staff's focus on competition at the aggregation level. Such entities will act as intermediaries between customers or customer groups and suppliers; in essence, they will become not only new buyers but also new sellers of power. Supply aggregators (such as power marketers) take title to power and resell it on the wholesale market. Load aggregators will group customers to increase buying power, optimize load factors, and otherwise capitalize on retail opportunities that might not otherwise be available should each customer be forced to make purchasing arrangements on its own.

---

6 By way of comparison, efficiency gains achieved by IOUs tend to be held by them between rate cases, and not shared by the ratepayers. In an open market, however, competition assures that a portion of

Aggregators would likely provide or procure: energy and capacity; customer billing and payment collection services; responses to customer requests for service, customer bill inquiries and customer complaints; demand-side management products and services that promote economic efficiency; inspection, new connection and installation services; and other energy services.

In the environment described above, where a vertically-integrated utility participates in both the market for wholesale generation services **<u>and</u>** provides the transmission network for these services to be delivered to distribution companies, issues related to self-dealing inevitably arise. Therefore, NGC supports Staff's position on ISO's and the ISA. However, as Staff implies, the introduction of an ISO (or ISA) alone will provide sufficient safeguards against the potential for exercise of vertical market power: the creation of an ISO (or ISA) merely holds out the promise that all players will have comparable access to the transmission system.

NGC has also debated and participated in negotiations involving the formation of ISOs. Despite their intellectual appeal, ISOs will not be the "be-all, end-all" panacea that many ISO advocates suggest. ISOs will not solve horizontal or vertical market power, self-dealing, and other related problems nearly as well as would divestiture. After all, ISOs are simply the result of an unsatisfactory compromise developed as an alternative to divestiture. Nonetheless, ISOs do have a role that could lead to increased efficiency and added liquidity in the wholesale market. Specifically, ISOs hopefully will eliminate transmission rate-pancaking and, by being a regional presence with the ability to assess the availability of capacity more effectively than an individual IOU, should allow marketers and utilities alike to move power more reliably and efficiently.

One of the most difficult problems in forming ISOs is inserting the "I" into the ISO, i.e., in assuring that the system operates "independently". Independence in this instance refers largely to the operation of the electric transmission system independent of the transmission owner's generation assets. As shown above, the traditional integrated

---

those gains, perhaps all, go directly and very quickly to the marketplace.

electric utility has tremendous incentives and opportunities to operate the system to favor its own generation assets and power marketing activities. Indeed, the traditional integrated electric utility essentially has an obligation to its stockholders to maximize generation-related profits through all legal means.

~~To the extent the generation owning IOU's must meet their obligation to maximize shareholder value, they will attempt – usually successfully – to establish the ISO in a manner will assure a market that favors their generation. This usually occurs through the establishment of ISO tariffs that favor generation owned by the transmission owners, through transmission pricing mechanisms that favor suppliers with captive customers onto which the risk of price uncertainty can be pushed, and through many other more subtle means.~~ Divestiture of generation will virtually eliminate the problem.

As alluded to above, without willing and able buyers in the marketplace market participants may have access, but they will not be able to compete in the market. Therefore, absent mandating divestiture, the Commission should require each utility under its jurisdiction to functionally unbundle its generation, transmission, and distribution functions. This requirement would include physical separation of personnel, as necessary, as well as the separation of costs and the unbundling of rates for the various operations of the utility.

NGC continues to doubt, -however, that functional unbundling alone can eliminate the potential for abuses of vertical "market power." In all likelihood, actual separation of the separate functions of the existing vertically-integrated utility is required to ensure fairness in the generation marketplace. As long as the "separate" functions of the vertically-integrated utility ultimately report to the same board of directors and the same shareholders, it seems hard to imagine uninfluenced decision-making on the part of one area of operations.

Finally, NGC applauds the Staff's recognition that the Commission's initial timeline for transition needs to be modified. It makes logical sense to allow entities with "schedulable" load to access competitive suppliers on January 1, 1999. Such a modification eliminates many of the issues that arise when a phased-in approach is utilized.

NGC looks forward to the continuing evolution of the Commission's restructuring initiative, as well as the opening of the marketplace in Arizona.

Respectfully submitted,

Barry N. P. Huddleston
Manager, State Regulatory Affairs
NGC Corporation